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Ukraine war: Enormous damage for Ukraine and Russia, turning point for Europe

- *Ukraine: economic collapse foreseeable, reconstruction will require massive support*
- *Russia: dissolution of economic relations with the West, war funding not threatened despite economic downturn, so long as EU imports Russian gas*
- *Europe: high inflation, rapid green transformation, EU integration of the Western Balkans, rearmament*

What are the economic implications of the war in Ukraine for Ukraine itself, Russia and the rest of Europe? In a new study, the Vienna Institute for International Economic Studies (wiiw) sheds light both on the immediate consequences, and on the medium-term structural changes caused by the biggest armed conflict in Europe since the Second World War.

Beyond the human suffering – involving thousands of deaths and millions of refugees – the economic damage is devastating, especially for Ukraine. Independent estimates put the material damage to infrastructure and buildings in the first three weeks of the war at around USD 63 billion. The Ukrainian government puts it at USD 565 billion, including economic losses and damage to the military. The regions of Ukraine so far directly affected by the war (including the capital, Kyiv) used to generate about 53% of GDP. *'Even if you leave out Kyiv, a third of industrial and agricultural production and about a quarter of total exports came from what are now war zones'*, calculates Olga Pindyuk, an economist specialising in Ukraine at wiiw. *'There, of course, the economy has collapsed.'* With Black Sea ports under attack by Russia and blockaded from the sea, Ukraine has lost more than half of its export capacity. The main exports have traditionally been grain and steel, and overall about a third of economic output in 2021 came from goods exports.

Nevertheless, Ukraine has so far displayed remarkable macroeconomic stability. As of mid-March, foreign exchange reserves amounted to USD 27.5 billion. The banking system has also been stable and liquid to date. *'However, the Ukrainian economy will start to falter massively, as the all-important foreign exchange revenues from exports start to disappear'*, says Pindyuk. Some relief could come from the substantial international financial assistance. Including a Ukrainian war bond that has been issued, this now amounts to around USD 18.5 billion.

Reconstruction will require massive financial aid

This does not alter the gloomy outlook for Ukraine. *'If many companies cease operations and unemployment rises, that will inevitably lead to a massive slump'*, points out Pindyuk. Banks must prepare for huge losses, because assets are damaged and loans can no longer be serviced. *'Everything depends on the further course of the war, so forecasts are difficult'*, says Pindyuk. Should Ukraine be divided in the longer term, the study assumes a strong recovery after the end of the war in the part that remains independent. According to that scenario, this unoccupied Ukraine would likely see the return of many refugees, would have strong ties to the West, would receive enormous

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financial support from Europe and the United States, and could possibly join the EU. Western investment could drive technological modernisation and productivity gains. In the event of partition, those territories under Russian control would be rebuilt much more slowly and would likely suffer from continued outward migration.

Russia: Disintegration of economic relations with the West

The aggressor, Russia, is also facing severe consequences. The Russian economy is expected to shrink by 7-8% in 2022 in the best-case scenario, and possibly by up to 15%. Inflation could rise to 30% by the end of the year, which will lead to a collapse in real household income and thus private consumption. *'Already we are seeing supply-chain problems in many sectors because of the sanctions. This and the withdrawal of many Western companies, for example in the automotive industry, is hitting industrial production hard'*, says Vasily Astrov, economist and Russia expert at wiiw. The economic stimulus package announced by the government to tackle the crisis will not really be able to solve these problems.

Although the Russian central bank was obviously surprised by having its foreign exchange reserves in the West frozen, it has since been able to stabilise the macroeconomic situation. *'Strict capital controls and exchange controls, regulatory relief for banks and a doubling of interest rates to 20% have prevented financial meltdown. The rouble exchange rate has recovered almost to its pre-war level'*, notes Astrov. But investor confidence has been undermined and credit costs are rising.

War financing not at risk without energy embargo

However, the West's drastic sanctions will only affect Russia's ability to wage war in Ukraine in the medium term. *'The Russian government still has enough fiscal leeway to be able to finance the war for longer'*, goes on Astrov. He believes that Russia is likely to run out of soldiers and modern weapons, before it runs out of money.

In the medium term, the outlook for Russia is largely negative. Businesses are losing their access to Western technology, due to the sanctions and the mass exodus of Western companies, and that will serve to reinforce the gap between Russia and the rich countries. Even more extensive trade with the Asian economies, especially China, will only partially compensate for this. Real incomes are likely to stagnate at a low level after the current slump. Fundamentally, the invasion of Ukraine has begun an unravelling of the economic links built up between Russia and the West over the past 30 years. *'Even if sanctions are eventually eased, February 2022 is likely to go down in the history books as a turning point, when Russia's integration into the European economy came to a juddering halt'*, says Richard Grieveson, Deputy Director of wiiw and co-author of the study.

Europe: High inflation due to energy prices and fundamental strategic change

In the rest of Europe, the war and sanctions are driving already high inflation to ever-greater heights, weighing on real incomes and dampening growth prospects. For Germany, it is estimated that each additional doubling of the price of natural gas reduces economic growth by 1% per year. *'Of course, the damage would be incomparably greater if the EU were to impose an energy embargo on Russia, or if Moscow were to stop supplying gas on its own initiative'*, says Grieveson. This would be especially true in Germany, Italy, Austria and the Eastern European EU members, which are particularly dependent on Russia for gas. *'Admittedly, a situation could arise – for example, if Russia were to use chemical weapons or commit further war crimes – in which even Germany, which has so far firmly rejected an energy embargo, would be forced by the great political pressure to support one'*, argues Grieveson.

In the EU, Russia's attack on Ukraine will bring about fundamental structural change at the strategic level. First, member states are likely to massively intensify their defence efforts, as also shown by Germany's about-face in this area. Second, the problematic dependence on Russian energy supplies will speed up the green transformation of the economy. *'Replacing Russian oil and gas with renewables in the medium term is a done deal in the EU'*, comments Grieveson. Third, the EU's economic integration in the Eurasian region with Russia is on the verge of collapse. *'The states in between will have to choose one of the two sides, and generally the decision will probably come down in favour of the EU'*, thinks Grieveson. And fourth, EU accession prospects for the Western Balkans could and should improve enormously. Ukraine shows how fragile only partial Western integration can be. *'Putin's invasion should have led to a realisation in most EU capitals that those countries should be admitted more quickly, to reduce the risk of instability and armed conflict'*, concludes Grieveson.

The study is available for download here.

About the Vienna Institute for International Economic Studies (wiiw)

wiiw is an economic think tank that has been producing economic analyses and forecasts for currently 23 countries in Central, East and South-East Europe for almost 50 years. In addition, wiiw conducts research in the areas of macroeconomics, trade, competitiveness, investment, the European integration process, regional development, labour markets, migration and income distribution.

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